FILED
APR 11 1927
WM. R. STANSBURY
CLERK

IN THE

Supreme Court of the United States

Docket No. [redacted] 71
File No. 31960

C. G. LEWELLYN, Collector of Internal Revenue for the Twenty-third District of the United States,

Petitioner,

vs.

ELECTRIC REDUCTION COMPANY, a corporation,

Respondent.

BRIEF OF AMICUS CURIAE.

DONALD HORNE,
Amicus Curiae,
120 Broadway,
New York City.

IN THE

Supreme Court of the United States

Docket No. 394

File No. 31960

C. G. LEWELLYN, Collector of Internal Revenue for the Twenty-third District of the United States,
Petitioner,

vs.

ELECTRIC REDUCTION COMPANY, a corporation,
Respondent.

BRIEF OF AMICUS CURIAE.

This brief, filed with the consent of the Court first had and obtained, is submitted in the hope of assisting in elucidating certain statutory provisions affecting the above-entitled action. Counsel submitting this case represents a client in a matter involving the construction of the same statutory provisions.

These provisions are paragraphs (4) and (5) of subdivision (a) of Section 234 of the Revenue Act of 1918, reading as follows:

> "Section 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> (5) Debts ascertained to be worthless and charged off within the taxable year."

In the instant case, it is contended that the transaction resulted in a loss, as distinguished from a worthless debt, and, in the writer's opinion, the facts justify that contention. It is his desire, however, to bring to the attention of the Court another phase of the situation.

The Treasury Department has from the beginning interpreted paragraphs (4) and (5) above quoted as separate and independent provisions, having no relation to each other. If a loss happens to fall in that class of losses in which the relationship of debtor and creditor exists, it cannot be deducted from gross income in the year in which the loss occurred unless the creditor ascertained it and charged it off his books within that year. Some courts have fallen into the same error; but, in justification, it may be said that, so far as we have been able to discover, the precise arguments now made have never before been presented in any court.

Paragraph (4) was clearly framed of necessity in order to eliminate from taxable net income a non-taxable return of capital. There could be no gain in a taxable period until losses sustained in attempting to make gain during that period were recouped.

Paragraph (5) was not, however, enacted under any such necessity, since paragraph (4) was broad enough to

cover the matter. Paragraph (5) was apparently an attempt at equalizing taxation, and was intended to benefit taxpayers and not to deprive them of rights which they would otherwise have had. The reason for its enactment was that because of the peculiar nature of losses resulting from debts becoming worthless it was recognized that it might frequently be impossible to determine in just what year such losses were sustained. In such cases, the taxpayer might not be able to bring its case within paragraph (4) and the benefit of Section 234 might be lost to it altogether, because of its inability to establish in what year it actually sustained the loss. Paragraph (4) is restricted to "losses sustained within the year."

In order to prevent this possible injustice, paragraph (5) was inserted to permit, as alternative relief, the deduction of worthless debts for the year in which the worthlessness was ascertained. It is obvious, therefore, that this provision was intended to be entirely beneficial to taxpayers. It was intended, not to lay down a hard and fast rule as to this class of losses, as distinguished from other losses sustained, but to enable taxpayers to establish their right to deductions for such losses in cases where it would have been impossible to prove in what year the loss was actually sustained. While it might be impossible to determine in what year a debt became worthless and therefore a loss, it would not be difficult for the taxpayer to show in what year it ascertained it to be worthless.

This remedial, salutary and beneficial legislation should not be so construed and applied as to cause it to work a hardship upon the persons it was intended to benefit. Yet that is what has been done by the Treasury Department. In many cases taxpayers have not known during the taxable year that debts became worthless, but have subsequently found out the exact time. In such cases the Treasury Department has allowed the deduction for the

year in which the loss was ascertained and has refused to allow it for the year in which it was actually sustained. This has often thrown the deduction into a year in which the taxpayer had no income, or in which the income tax rates were lower than in the year when the loss was sustained. The instant case is an excellent example of the injustice resulting from such administration of paragraph (5). In this case the time when the loss was sustained was definitely determined. There was therefore no reason for the application of paragraph (5), whether or not the loss arose from the relationship of debtor and creditor. This was not one of the cases for which paragraph (5) was intended to afford relief. Here it works a hardship, as administered, since it places the deduction in a year when there was not sufficient income to absorb it, and there was no excess profits tax, although the loss was sustained in a year when there was a very high excess profits tax.

A loss may be sustained in one year but not discovered until a later year. This does not render it not deductible for the year in which sustained, for the reason that in determining correct taxable income the true facts should govern, and not only those of which the taxpayer has knowledge during the year. Adjustments and corrections may be made in subsequent years, and Congress has recognized the necessity for this by providing that deficiencies may be assessed, and refunds of overpayments made within five years after the return was filed, or for longer periods under certain conditions prescribed by law. It has also provided that suits may be brought to recover overpayments of taxes without the necessity of alleging payment under protest or duress. Discovery after the expiration of a taxable year of facts pertinent to the determination of the income and profits taxes for that year may be given effect by filing an amended return. The necessity for such corrections is recognized and the procedure prescribed in

Article 111 of Regulations 45 and the corresponding article of Regulations 62 of the Bureau of Internal Revenue. A portion of the latter reads as follows:

> "If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained."

So that if, during the period within which adjustments may be made, the taxpayer discovers that a loss was sustained in a prior year, he is permitted to correct his return for that year and take the loss. There is no reason why the same procedure should not be followed with respect to worthless debts, provided the year in which they become worthless can be established.

There are many cases in which facts are subsequently ascertained which definitely show that debts became worthless in prior years. For example, a debtor may become insolvent but the taxpayer creditor has a lien on certain property which, as far as it knows, is adequate security. It may later discover that this property was at that time subject to a prior lien, as, for instance, a debt or taxes due the Government, which left no assets for distribution to the creditor taxpayer. Here the loss was definitely sustained, because of the prior lien, say, in 1918, when the tax was at the rate of 82.4%. In 1922, when the tax was 12½%, taxpayer first ascertains that its security was subject to such prior lien, and that its debt was worthless in 1918. Under present administration

of the tax laws, this taxpayer is not heard to say that the loss was sustained in 1918 and the deduction applicable to that year; it is required to take the deduction in 1922, provided it charged the amount off its books in 1922. It paid tax on receipts which merely replaced its lost capital in 1918, at 82.4%; it abates its tax on the same amount, in 1922, but only at 12½%. The net result is that it has paid a tax on a recoupment of capital, before any gain was derived, at 69.9%. The tax statute was obviously not intended to produce this result.

This, however, is not the only unjust and illegal effect of the Treasury Department's interpretation of this part of the law. By applying what it considers a strict and literal construction of the language of paragraph (5), it requires as conditions for the deduction of a worthless debt, first, that it be ascertained to be worthless within the taxable year, and second, that it be charged off within the taxable year. Thus, if a taxpayer, using its best judgment, but without adequate evidence, charges a debt off in one year, but cannot prove definitely that it ascertained it to be worthless in that year, it can never have the benefit of the deduction for any year, even though it can absolutely establish when the loss was actually sustained. Conversely, if a taxpayer ascertains a debt to be worthless in one year and charges it off in a later year, it can have no deduction for any year. It is hard to believe that the law was intended to operate in this way. The year when the capital loss was recovered is ignored entirely, income is created by bookkeeping entries, and a self-serving declaration by a taxpayer is made necessary evidence in his favor by this construction.

A more sensible construction is that paragraph (4) governs in every case; but where its conditions cannot be complied with, because of lack of evidence as to when the loss was actually sustained, the taxpayer is given another

chance. It can prove when it ascertained the loss, and deduct it for that year. The provision regarding charging off is for administrative purposes, to prevent allowance of the same deduction twice. As such it is a condition which may be performed retroactively, in compliance with the statutory requirement. It is not evidentiary, except as it may apply against, rather than in favor of, the taxpayer. Its proper use is as a disserving, rather than as a self-serving, declaration. And if the charge-off is made in the wrong year, the error should be subject to correction without invalidating taxpayer's deduction. It is submitted that this is a fair and reasonable construction of the statute, within the language used, even if strictly construed, and does substantial justice, while the construction urged by the Government is absurd, harsh, unjust, unnecessary, and not warranted by the language of the statute.

Respectfully submitted,

DONALD HORNE,
Amicus Curiae.